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RULE 10b-5 AS AN ADAPTIVE ORGANISM

DONALD C. LANGEVOORT*

In this Article, Professor Langevoort examines the adaptive qualities of Rule 10b-5 and how the rule has remained intact despite sweeping changes in the intellectual and political landscapes in which it operates. In Professor Langevoort's view, Rule 10b-5's survival is largely due to the flexibility of its language which has enabled the rule to embrace malleable social perceptions of the securities market and the securities business.

Professor Langevoort also addresses the question of whether Rule 10b-5 has outlived its usefulness and should therefore be repealed and replaced by more precisely-drafted legislation. Professor Langevoort concludes that Rule 10b-5's continued survival is indeed appropriate in light of society's incomplete understanding of how investors make decisions. Professor Langevoort further concludes that a complete revision of Rule 10b-5 is highly unlikely—in part because the ambiguity of the rule's present language provides an attractive alternative to the difficult risk-allocation decisions that would have to be made by lawmakers in formulating substitute legislation.

INTRODUCTION

METAPHORS abound in descriptions of Rule 10b-5. Justice Rehnquist's portrayal of the rule as a "judicial oak that has grown from little more than a legislative acorn"¹ is undoubtedly the best known. Continuing in the genre of the natural sciences, I would like to draw the Darwinian image of Rule 10b-5 as an organism readily adapting to changes in both its cultural and political ecology. The rule's unique adaptive capacity at the very least explains why it has survived intact for some fifty years, and gives us reason to doubt that revision will occur at any time in the foreseeable future.

The attribution of a fluid character to Rule 10b-5 is not a novel insight. The rule has long been praised as being sufficiently open ended so as to avoid presenting a blueprint for fraud, tempting the "'versatile inventions of fraud-doers.'"² Its lines are sufficiently indistinct that a cunning operator cannot confidently step close but not over. The rule can also readily reach new schemes and tactics. However, while flexibility is plainly a virtue from an enforcer's perspective, the price of indeterminacy is obvious: a loss of notice that permits legitimate actors to behave in a

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1. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). For other metaphors, see Louis Loss, *Fundamentals of Securities Regulation* 726 (2d ed. 1988).

2. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 199 (1963) (quoting *Stonemets v. Head*, 154 S.W. 108, 114 (Mo. 1913)); see *id.* at 193 n.41 (discussing flexibility of definition of fraud in equity jurisprudence).

manner unchilled by the fear of legal liability. That sort of adaptability, while true, is not what especially interests me.

Rather, my claim is intellectually more basic. Over the course of time, American society (or at least its relevant segments) has told a multitude of stories about the way in which the world of securities and investments works—who its actors are, why they behave as they do, and the mix of function and dysfunction, good and evil. This socially constructed image of the investing “reality”³ has evolved considerably since the 1940s, and continues to change today. What is both intriguing and important about this development is the extent to which Rule 10b-5 so easily embraces new ideas and images about investing that achieve some level of elite social consensus, yet just as quickly abandons them without serious damage when these new ideas lose currency. This strikes me as evincing a much more powerful adaptive capacity than the simple ability to reach new forms of fraud. In sum, Rule 10b-5 is remarkably well suited to operate as a centerpiece in securities regulation *precisely because* we as a culture have not yet created a consistent, persuasive story of what the business of investing is all about.

I. STORIES ABOUT INVESTING

As individuals, each of us has some direct access to information about the investment process: our own experiences in buying or selling securities, the experiences of friends or family in such matters, or perhaps through our own personal contacts with someone in the securities business.⁴ From these highly biographical bits of data, we can mentally construct skeletal stories about the investing process—a term which this Article uses to describe the entire range of actors, institutions and phenomena bound up in the trading of securities. But, apart from those “in the business,” few individuals have the base of experience to build anything close to a coherent explanation about what the investing process entails, and those in the industry often have perspectives that are exceedingly subjective and potentially misleading.⁵ The process of “social

3. Social constructionism is an intellectual genre that emphasizes the socially-invented nature of much of what we consider knowledge. The seminal work on this subject is Peter L. Berger & Thomas Luckmann, *The Social Construction of Reality: A Treatise in the Sociology of Knowledge* (1967). An effort to draw on this literature in the analysis of legislative process is set forth in Edward Rubin, *Beyond Public Choice: Comprehensive Rationality in the Writing and Reading of Statutes*, 66 N.Y.U. L. Rev. 1, 4 (1991).

4. This Article uses the term “socially-constructed reality” to refer to the ways that people collectively make sense of the external world and explain it to others. More formally, such cognitive maps are frequently referred to as schemas—sets of mental representations that provide interpretive guidance in the presence of ambiguous stimuli. See Susan T. Fiske & Shelley E. Taylor, *Social Cognition* 98 (2d ed. 1991).

5. As social psychologists often point out, that which is relevant to our personal experience is typically overweighed in creating an understanding of the world at large. As a result, for example, a stockbroker who works in a highly stressful but highly ethical environment is likely to see the securities business in that light, and treat wrongdoers as aberrant. This tendency to overweigh personal experience (egocentric reasoning) is the

learning” completes the image;⁶ our perceptions about the investing process are shaped through our education, accounts presented by the media, the books and articles that we read, our conversations with others, and so on. The interplay between personal and external sources of information varies considerably among people, and hence each of our stories will differ considerably. Legal academics, for instance, draw from different (but probably no less biased) information sources than both practicing lawyers and laypeople.⁷ In the aggregate, however, common themes, images, and ideologies can and do emerge in people’s construction of the investing process.

The substantive content of our constructed reality changes with moderate velocity. To some extent, it will at any given time reflect objective fact—for example, the highly institutionalized nature of the current market for large stocks and the growing internationalization of the marketplace as a result of rapid changes in the technology of market-linkages color our perspective of the investing process as it exists in 1993. Nevertheless, the current scholarship on constructed realities points to the important role that motivational influences play.⁸ For example, cultural attitudes are shaped by emotional forces—such as ego, greed and envy—that in turn will reflect, among other things, social and economic status.⁹ Aggregate changes in relative status, or in perception about relative status, will alter prevailing attitudes in both the subjective construction of the investing process, and in social learning about this process.¹⁰ Levels of executive compensation that might be seen as a dynamic form of marketplace incentive in an expanding economy have a very different meaning in a persistent recession.¹¹ In this sense, the social reality possesses a strong political component. Indeed, the social reality may be discernable more through iconography than through econometrics.

basis, it is said, for much human misunderstanding. For an intriguing article, see Dale W. Griffin & Lee Ross, *Subjective Construal, Social Inference and Human Misunderstanding*, 24 *Advances in Experimental Soc. Psychol.* 319 (1991).

6. The pervasiveness of social learning—the tendency to look to others who might have superior knowledge to help interpret ambiguous cues—has received ample empirical support. See, e.g., Elliot Aronson, *The Social Animal*, chs. 3-4 (6th ed. 1992); Robert B. Cialdini, *Influence: Science and Practice*, ch. 4 (2d ed. 1988).

7. The unavailability and the ambiguity of empirical data, coupled with the professional distance that most legal academics maintain from the day-to-day workings of the worlds they study, lead to a high—and circular—reliance on social learning (the pronouncements of colleagues, etc.) and hence a substantial risk of bias.

8. See Aronson, *supra* note 6, at 202-03; Anthony G. Greenwald, *The Totalitarian Ego: Fabrication and Revision of Personal History*, 35 *Am. Psychol.* 603 (1980). These influences include the desire to view oneself as the focus of knowledge, the desire to view positive—but not negative—outcomes as a result of one’s actions, and the desire to preserve one’s preconceived notions about the way the world works. See Greenwald, *supra*, at 603. They also encompass one’s desire to view oneself as possessing a truthful character. See Aronson, *supra* note 6, at 202.

9. See Aronson, *supra* note 6, at 202-03; Greenwald, *supra* note 8, at 603.

10. See Aronson, *supra* note 6, at 202-03; Greenwald, *supra* note 8, at 603.

11. See Aronson, *supra* note 6, at 202-03; Greenwald, *supra* note 8, at 603.

Since judges make the law of Rule 10b-5, their aggregate perspectives are crucial. Moreover, since the pool of federal judges is highly atypical—dominantly white, male, and relatively wealthy—we must tread carefully in discerning their construction of reality. Undoubtedly, judicial attitudes have been shaped by both the judges' personal investment experiences and contacts over the course of their careers with the investing process. Justice Powell, for instance, had an exceptionally strong influence on the securities law jurisprudence of the 1980s; unmistakably, his attitudes reflect his years as a "white shoe" corporate counsellor.¹² Judges, however, are also subject to the perhaps disproportionate influence of elite external sources of information, including conversations with other elites, articles appearing in the *New York Times* and the *Wall Street Journal*, and sometimes even academic writings.¹³ Their views are bound to be more sophisticated, and less volatile, than those of the public at large. Nevertheless, they are by no means static.

Before turning to Rule 10b-5 for illustrations, we might profitably look at the recent takeover phenomenon for a salient example of the coincidence between elite economic perspectives and the prevailing case law—in this instance, as a matter of state law. Up through the mid-1970s, there was at best an ambivalence about takeover bids, and the term "raider" was often used to describe the takeover bidder.¹⁴ Then, in a dramatic turnaround in ideology that would prevail throughout most of the 1980s—perhaps attributable to the stunning premiums being paid to investors—the prevailing commentary departed from its earlier stance and embraced takeovers for both their efficiency and wealth-creating effects.¹⁵ Since then, for a variety of reasons, criticism has been reascendent. The law regarding the scope of discretion given to management to resist a takeover can be plotted in a way that shows an identical pattern: from the business-judgment approach of the late 1960s,¹⁶ through the heavy judicial scrutiny signalled in Delaware by the *Unocal* and *Rev-*

12. See Catherine A. Barnes, *Men of the Supreme Court: Profiles of the Justices* 119 (1978). This is particularly evident in his opinions on corporate takeovers. See, e.g., *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987); *Edgar v. MITE Corp.*, 457 U.S. 624, 646 (1982) (Powell, J., concurring in part).

13. This is not to say that judges are particularly influenced directly by academic writings, although they may be in certain instances. But, academic writing at some level does diffuse into cultural understandings through a variety of means, especially if there is a political demand for particular points of view. See Martha Derthick & Paul J. Quirk, *The Politics of Deregulation* 246 (1985).

14. The late 1960s brought both federal and state regulation of bidder activity. See Robert C. Clark, *Corporate Law* §§ 13.3-.5 (1986). The normative skepticism is nicely captured in the title of one of the leading business articles of the time, Russell A. Taussig & Samuel L. Hayes, III, *Are Cash Take-Over Bids Unethical?*, *Fin. Analysts J.*, Jan.-Feb. 1967, at 107.

15. The classic article in this genre is Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161 (1981).

16. See, e.g., *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964).

lon cases in the early and mid-1980s,¹⁷ followed by the dramatic retrenchment in the *Time* case in 1989.¹⁸ While the causal relationship between perception and doctrine cannot be proved, the inference is hard to resist.¹⁹

II. RULE 10b-5 AND THE SOCIAL CONSTRUCT OF INVESTMENT

Lacking both the time and experience to consider the entire fifty years of Rule 10b-5's intellectual history, this Article will concentrate in this section on its latter half—roughly from 1968 to the present. The methodology will be straightforward, if speculative:²⁰ first, this Article will recreate as much as possible the changing views of the investing process that were reflected in elite sources of information (as well as objective fact), and then it will examine the extent to which the law under Rule 10b-5 has mirrored these shifts in perception.

The literature and expressions of the first phase of this period was dominated by the sense—growing obsolete, even then—of the individual nature of investing. The 1960s especially reflected broad household participation in the securities markets. The characterization of stock ownership was very much in the Berle/Means genre of dispersed individual owners largely powerless in the presence of entrenched managerialism. So stated, the general concern of securities regulation—and the antifraud rules, in particular—was essentially consumer protection to be accomplished through full disclosure, mediated by an aggressive use of legal

17. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985). Both cases held that defensive efforts should be subjected to an "intermediate" standard of review, with management bearing the burden of demonstrating a threat to the company and a considered, proportionate response thereto. See *Unocal*, 493 A.2d at 954-55; *Revlon*, 506 A.2d at 180.

18. See *Paramount Comm. Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989) (applying the intermediate standard of review, but giving wide scope to defensive efforts based on little more than a potentially self-serving business preference for an in-place acquisition program).

19. This claim was ably advanced in Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 Colum. L. Rev. 1931 (1991). Elsewhere, I have argued that the Supreme Court jurisprudence on the legitimacy of state statutory regulation of takeovers has been heavily affected by changes in intellectual perception. See Donald C. Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp. v. Dynamics Corp. of America*, 101 Harv. L. Rev. 96, 102-03 (1987).

20. Reconstructing the past for purposes of intellectual history is a difficult task, in part because of the revisionist tendencies of collective memory. I have not systematically sought to review the entire popular and academic literature, if indeed that by itself would demonstrate a historically valid description of the prevailing social construct. However, I have a fair degree of intuitive confidence in the description, and it coincides with mainstream accounts of the history of investing and securities regulation, and with collections of legal materials of the times. See, e.g., Joel Seligman, *The Transformation of Wall Street* (1982) (a history of SEC regulation); Robert C. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 Harv. L. Rev. 561 (1981) (providing a history of the shifting roles of investment).

institutions.²¹ Intellectually, this period was dominated by the first great scholars of securities regulation, particularly Louis Loss.²²

In this environment, Rule 10b-5 flourished. Nineteen sixty-eight was the year of the Second Circuit's *Texas Gulf Sulphur* decision,²³ perhaps the watershed event in the rule's history. There, the court not only established Rule 10b-5 as the principal weapon against insider trading, but even more significantly, authorized sanctions against issuers who do not tell the public the entire truth, unencumbered by notions of privity or near-privity.²⁴ Three years later, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,²⁵ the Supreme Court rendered its first decision under Rule 10b-5, with the same consumer protection flavor.²⁶

The later 1970s were a transition period, characterized by doctrinal retrenchment at least in the Supreme Court.²⁷ It is easy to ascribe political motivations to this process of curtailment, which represents a more business-oriented perspective on the potential for abuse in class and derivative litigation. Three other factors were perhaps just as significant. The first was the intellectual environment, which saw a dramatic increase in the dissemination of conservative points of view concerning the "excesses" of securities regulation within the intellectual media (e.g., books, law reviews, and the business press).²⁸ This reflected a natural classical impulse: the desire to impose order and restraint on a doctrine that had grown, in a burst of creativity, from little more than the desire to help the fragile investor. The 1970s, then, saw less coherence, and more dissonance, in the constructed reality available to the judiciary.

The second factor—extending well beyond securities law—was a growing disillusionment with ostensibly protective institutional structures. Much of the 1970s was marked by attacks on the stock exchanges as anti-competitive cartels that existed for the benefit of its members, and not the public.²⁹ The SEC as a bureaucracy, and the legal doctrines girding the existing system, were increasingly seen in shades of gray rather than black or white.

21. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (articulating a rule of disclose or abstain with regard to inside information), *cert. denied*, 394 U.S. 976 (1969).

22. See generally Louis Loss, *Securities Regulation* (2d ed. 1961 & Supp. 1969).

23. See *Texas Gulf Sulphur Co.*, 401 F.2d at 833.

24. See *id.* at 860-61.

25. 404 U.S. 6 (1971).

26. See *id.* at 12.

27. See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (imposing deception requirement); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (imposing scienter requirement); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (imposing purchaser-seller requirement for private rights of action).

28. I do not wish to suggest any sense of orchestrated intellectual manipulation. The work of some of securities regulation's most notable scholars during the early 1970s—e.g., Alan Bromberg, Louis Lowenfels, David Ruder, Robert Mundheim—fell into this moderately conservative, or classical, genre.

29. See Seligman, *supra* note 20, at 398; Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & Econ. 273 (1984).

The final—and perhaps most subtle—factor was the shift in the pattern of investing from the individual to the institution. By the 1970s, elite sources of information discovered what for some time had been a trend—the increasing tendency of households to invest through intermediaries, such as pension funds and mutual funds. Fewer people saw themselves as active investors, and the prevailing characterization of the investing process placed less emphasis on consumerism, and more emphasis on the movements of large blocks of capital to which individual trades seemed mere appendages.³⁰ In many ways, the distance between people and securities grew.

The late 1970s and early 1980s brought the most fundamental intellectual change of the last twenty-five years of securities regulation: the shift in emphasis from legal institutions to the free market as the primary mechanism for protecting the investor. Building on the concerns about market structure that were echoed in the 1970s³¹ (which led to the Securities Acts Amendments of 1975),³² economists and legal scholars began in earnest to identify a myriad of contexts in which investors would seemingly be better off through a decrease in regulation.³³ Central to this endeavor was the efficient market hypothesis: the view, strongly endorsed by a growing body of research, that the financial markets operated in ways that impounded new information almost instantly into stock prices, such that the prevailing price could—absent fraud—be trusted as the correct price.³⁴ Soon, as I have described in some detail elsewhere,³⁵ this idealization of the market quickly diffused from academia to a variety of other settings, including the law.

The effect of the efficient market hypothesis upon Rule 10b-5 has been quite dramatic. The efficient market hypothesis has provided the intellectual underpinning for the so-called “fraud on the market theory”—the idea that investors can recover damages in instances of corporate fraud even without a showing of actual reliance on the misstatement or omission, under the presumption that the investors relied on the integrity of

30. The classic exposition of this change is Clark, *supra* note 20, at 576, who described this as the “third” phase of capitalism. The fourth phase involves even further distance, as the individual loses even the control over the investment adviser. *See id.* at 579.

31. *See supra* notes 29-30 and accompanying text.

32. Securities Acts Amendments of 1975, 15 U.S.C. § 78(b)-(d) (1988).

33. Early on, Henry Manne labored almost alone in legal academia, building on the work of economists like George Benston and George Stigler. Later, he was joined by a host of scholars, of whom the most notable have been (now Judge) Frank Easterbrook and Daniel Fischel. Today, it is fair to say that nearly all significant work in theoretical securities regulation—that of scholars like Roberta Romano, Ronald Gilson, Reinier Kraakman, John Coffee, Lucien Bebchuk, Jon Macey, Geoffrey Miller, Ian Ayres, Lynn Stout, Jeffrey Gordon, Bernard Black, and the like—operates from an efficiency paradigm, even though there is substantial disagreement regarding the appropriate conclusions within that framework.

34. *See* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851, 851 (1992).

35. *See id.* at 873-903.

the market price (i.e., market efficiency) when they bought or sold their investments.³⁶ Curiously, this use of economic theory expanded rather than contracted the scope of liability. In fact, the elite's cultural embrace of finance theory in adopting the efficient market hypothesis—acting as though economics had made the presumption of reliance a doctrinal inevitability—may have blinded the courts to the costs associated with expanded liability. The literature is only now beginning to take notice of this.³⁷

Two other “deregulatory” uses of market efficiency under Rule 10b-5 were also quite noticeable. In the law of insider trading, the Supreme Court's decisions in *Chiarella v. United States*³⁸ and *Dirks v. Securities & Exchange Commission*³⁹ were heavily influenced by the Court's desire to recognize the ability of some market participants—especially investment analysts—to exploit informational advantages free of the chill of the rule, under the assumption that such exploitation is at the heart of market efficiency and therefore is of value to all investors.⁴⁰

The other significant use of the efficient market hypothesis has been in the development of a theory converse to the fraud on the market theory, sometimes called the “truth on the market theory.” Underpinning this theory is the idea that an investor should not be able to state a claim under Rule 10b-5—even though he or she may have been plainly deceived by misinformation—unless the market as a whole was also deceived.⁴¹ Under this approach, a showing by econometric data that the market has discounted the fraud will bar all investors from recovering for the fraud.⁴²

Although the case law under Rule 10b-5 has not yet clearly demonstrated it, we may be near—if not at—the end of the market idealization phase. During the late 1980s, economists became increasingly skeptical

36. See *Basic Inc. v. Levinson*, 485 U.S. 224, 241-47 (1988).

37. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 Stan. L. Rev. 1059 (1990). It is particularly interesting that legal and economics scholars who have assailed securities regulation as excessive and chilling have nevertheless tended to embrace the fraud on the market theory with unbridled enthusiasm, as though they were asserting some sort of intellectual parentage. See, e.g., Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907 (1989).

38. 445 U.S. 222 (1980).

39. 463 U.S. 646 (1983).

40. See Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 Hofstra L. Rev. 127 (1984).

41. See *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989). The truth on the market theory is largely uncontroversial in principle, because if in fact the market has not been fooled, then the price at which the deceived investor traded was not an unfair one. The difficulty arises in determining whether the market was indeed fooled, and the courts in both *Apple* and *Wielgos* have presumed that the market was efficient. See Langevoort, *supra* note 34, at 905-09.

42. See Langevoort, *supra* note 34, at 904.

of strong claims of financial market efficiency.⁴³ In the wake of this skepticism, "noise" theorists have begun to develop credible alternative models of investor behavior that recognize the role played by mood swings and other "irrational" phenomena in determining the price of a security.⁴⁴ Moreover, in the aftermath of the insider trading and manipulation scandals involving Ivan Boesky and Michael Milken, the stock market crash of 1987, and the recession, the social and political environment has become increasingly suspicious of the markets themselves.⁴⁵

It is possible, therefore, that we are at the beginning of another shift in the jurisprudence of Rule 10b-5. In light of the general public's diminished direct participation in equity investing,⁴⁶ this shift in jurisprudence may perhaps be toward greater moralism and the assessment of blame on those who hold immense economic power and status. This shift, however, would most likely be unaccompanied by the pretense of an "investor as consumer" analogy in light of the unalterable nature of today's institutional marketplace for corporate securities.⁴⁷ The process of adaptation in the jurisprudence of Rule 10b-5 is constant; it is only the direction of this adaptation that is difficult to discern.

III. THE NORMATIVE QUESTION, AND THE LAWYERS' BET

As this Article earlier discussed, Rule 10b-5 can and does adapt to changeable social perceptions of the securities markets and the securities business.⁴⁸ Adaptability, however, is not necessarily a virtue, especially when social constructs are so malleable and so readily influenced by politics and emotion. We must turn, then, to the question of whether the rule has outlived its usefulness and should therefore be repealed and re-

43. For a good survey of the new economics literature, see Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J. Econ. Literature 1583 (1989).

44. Much of this literature is reviewed in Robert J. Shiller, *Market Volatility* (1989). A succinct description of a plausible version of noise theory is set forth in Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. Econ. Persp., Spring 1990, at 19.

It may be of interest to note that one scholar has in fact analogized the use of the efficient market hypothesis to having a "near-death experience" in the economics literature. See Peter Fortune, *Stock Market Efficiency: An Autopsy?*, New Eng. Econ. Rev., Mar.-Apr. 1991, at 17, 35.

45. It is probably not coincidental that the diffusion of market-trusting norms into the law was roughly contemporaneous with the dramatic increase in stock prices over most of the 1980s, along with the careful placement of market-oriented thinkers, such as Frank Easterbrook and Richard Posner, into the federal judiciary.

46. See Carolyn K. Brancato, *Institutional Investors and Corporate America: Conflicts and Resolutions—An Overview of the Role of Institutional Investors in Capital Markets and Corporate Governance: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 101st Cong., 1st Sess. 6 (1989).

47. This more populist phase would in some ways be reminiscent of what Robert Clark refers to as the first phase of capitalism, in which the image of the "robber baron" became vivid—albeit in a very changed political environment. See Clark, *supra* note 20, at 562.

48. See *supra* part II.

placed by a series of more precise statutory and regulatory initiatives. The call for the repeal of Rule 10b-5, which was most recently echoed by David Ratner,⁴⁹ has been heard periodically over the last two decades. It, in fact, constituted a significant part of the American Law Institute's ill-fated Federal Securities Code.⁵⁰

The arguments for repealing Rule 10b-5 are formidable. One may plausibly contend that since the 1940s, our understanding of the securities marketplace has evolved to such a point where, as with a fine lens, we can now view matters with sufficient clarity as to allow ourselves to formulate sensitive policy predictions that are designed to achieve optimal results. Indeed, few who have any substantial experience in this area (myself included) are without ideas for distinct improvements over the current state of affairs.

Even conceding this, however, we must pause at the daunting nature of the task. Do the policy-makers really know enough about the investing process to do much more than guess at the costs and benefits of reform? My suspicion is that we actually know frighteningly little; rather, Rule 10b-5's intellectual wobble⁵¹ is the product not only of politics and emotion in the face of marketplace change, but the lack of convincing insight into the *objective* reality of investing. Although we have mounds of facts and figures and a reasonable sense of who the players are, their thoughts and motivations are dimly illuminated. The process of investing remains a great mystery, inviting the sort of volatile cultural speculation we have observed. The New York Stock Exchange can still be seen both as capitalism's cathedral and its casino on the Hudson.

In the early 1970s, there was interest in studying investor behavior seriously, using the tools of psychology and sociology.⁵² The SEC staff, building on its field study of the securities markets in the 1960s, looked closely and systematically at institutional investor behavior—the context in which buying and selling decisions are made, and the conflicts that

49. See David L. Ratner, *Repeal SEC's Anti-Fraud Rule*, Legal Times, May 25, 1992, at 22.

50. The Federal Securities Code (Am. Law Inst. 1980) was a comprehensive recodification of the securities laws which failed politically for a number of reasons, even though it had succeeded in getting the backing of the American Law Institute, the SEC, and a fair segment of the private bar. See Louis Loss, *Fundamentals of Securities Regulation* 40-44 (2d ed. 1988). Among other things, the Code took too long to prepare: by the time it was finished, many of its best ideas had already been adopted by the courts and the SEC in specific initiatives, and the case law had shifted (especially under Rule 10b-5) to a more conservative posture, reducing the need for revision in many people's eyes.

51. The term "wobble" is used to capture the vacillating, sometimes random nature of the case law. See Lea Brilmayer, *Wobble, or the Death of Error*, 59 S. Cal. L. Rev. 363, 366 (1986).

52. See Paul Slovic et al., *Analyzing the Use of Information in Investment Decision Making: A Methodological Proposal*, 45 J. Bus. 283 (1972); Paul Slovic, *Analyzing the Expert Judge: A Descriptive Study of a Stockbroker's Decision Processes*, 53 J. Applied Psychol. 255 (1969).

occur.⁵³ By the middle of the decade, however, the arguments in favor of the efficient market hypothesis had become sufficiently dominant so as to result in the dismissal of behavioral studies as irrelevant.⁵⁴ Indeed, if one accepts the premise that market forces remove all significant behavioral imperfections, a study of nonsystematic flaws or problems should not further an analysis of the market. Rather, event studies—the use of regression analysis to determine the response of the market as a whole to new information or events⁵⁵—became *the* methodology for studying investment behavior. The validity of the efficiency hypothesis assumed, economic theory could provide all the necessary direction for policy reform. Indeed, by the mid-1980s, scholars had put forth with confidence a wide-ranging program for refining or revising Rule 10b-5,⁵⁶ and had gained a substantial following at the SEC, in the courts, and (especially) in the business community.⁵⁷

As noted earlier, however, the last few years have demonstrated a loss of both cultural and scholarly confidence in the marketplace ideal. Noise theory has become the new fad, offering a more chaotic image of market behavioral flaws that do not readily wash out in real financial markets.⁵⁸ With these new developments, the need to revisit the behavioral questions has grown, and we now recognize that nearly two decades have been lost—though by no means wasted⁵⁹—in the pursuit of a further un-

53. See Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 64, 92d Cong., 1st Sess., pt. 1 (1971).

54. In his important work in the 1970s, Homer Kripke speculated about the extent to which individual investors made use of disclosure documents at all—an interesting behavioral question—but essentially dismissed the question by shifting concern to market-wide behavior as the proper focus of disclosure policy. See Homer Kripke, *The SEC And Corporate Disclosure: Regulation In Search Of A Purpose* 97-107 (1979); Homer Kripke, *The Myth of the Informed Layman*, 28 Bus. Law. 631, 636 (1973) (minimal use of disclosure documents by investors).

55. See Stephen J. Brown & Jerold B. Warner, *Using Daily Stock Returns: The Case of Event Studies*, 14 J. Fin. Econ. 3, 3-4 (1985). Through the use of event studies, the effects of regulation on a particular firm may be determined by separately analyzing the stock price movements that are attributable to either the market as a whole or to industry segments. The unaccounted-for return on investment is the “abnormal” return. See *id.* at 4. Similar techniques can be applied to groups of firms, provided that there is a sample of unaffected firms that are reasonably comparable in all other respects. See *id.* For a noteworthy application—which had an important influence in policy formulation—see Ronald Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807 (1987).

56. The most comprehensive program can be found in Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 276-314 (1991); see also Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611 (1985) (suggesting a framework for computing damages in securities cases).

57. See, e.g., Securities Act Release No. 33-6499, 48 Fed. Reg. 52,889, 52,892 (Nov. 23, 1983) (Securities and Exchange Commission support for refining or revising Rule 10b-5); *supra* text accompanying notes 37-42 (court support for revision).

58. See *supra* text accompanying notes 44-45.

59. The process of hypothesis formulation and testing has yielded a far more sophisticated understanding of the workings of the markets, even though the ultimate conclusion may be that of significant chaos. In addition, it is generally acknowledged that the mar-

derstanding of the behavioral mechanisms of the investing process.

First, it must be noted that we lack a systematic, empirical understanding of how investors make decisions—a crucial component to assessing the materiality and reliance portions of Rule 10b-5. To what extent are trading decisions influenced by noninformational factors? Two social scientists at Duke and the University of North Carolina, William O'Barr and John Conley, have recently done interesting work that addresses these questions.⁶⁰ Using the field work methods of cultural anthropology, they have explored the investment behavior of pension fund managers.⁶¹ Consistent with the new skepticism, they found that traditions, egos and personal relationships heavily affected managerial decision-making, competing with—though by no means excluding—the use of fundamental financial analysis.⁶² This is a step toward greater understanding, though one that suggests that the objective reality we seek may be far less than coherent and predictable. Comparable work, coupled with empirical testing, still needs to be done on a multitude of factors that may influence the decision-making processes of investors. Among the factors that remain to be explored are the role of investment research, the influence of the financial media, and the effects of the broker-customer relationship.

Also lacking is a solid perspective on the behavior of the primary subjects of Rule 10b-5's reach—issuer managers and their associates. Our society has long believed in the presence of a fairly sensitive correlation between legal rules and corporate manager behavior. This belief undoubtedly predated the efficiency paradigm, although it was substantially strengthened by that model's primacy. Indeed, Rule 10b-5's behavior-shaping capacity has been widely assumed, as reflected in its scienter and duty components.⁶³ But here again, there may be reason to question whether we have a sufficient understanding of the behavior of issuer managers and their associates to support a thorough analysis. There may be reason to doubt, for example, whether corporate managers have the cognitive capacity to recognize clearly the potential for harm in what they say and do⁶⁴—a possibility that would cause us to rethink the benefit

kets behave efficiently—at least to some degree. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 551 (1984).

60. See William M. O'Barr & John M. Conley, *Fortune & Folly: The Wealth and Power of Institutional Investing* (1992). The O'Barr and Conley research is summarized in John M. Conley & William M. O'Barr, *The Culture of Capital: An Anthropological Investigation of Institutional Investment*, 70 N.C. L. Rev. 823 (1992), and critiqued in Geoffrey P. Miller, *The Culture of Capital: Comments on Conley & O'Barr*, 71 N.C. L. Rev. 501 (1993).

61. See O'Barr & Conley, *supra* note 60, at 74-94.

62. See *id.*

63. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-06 (1976) (scienter component); *United States v. Chestman*, 947 F.2d 551, 570-71 (2d Cir. 1991) (duty component).

64. See generally Irving Janis & Leon Mann, *Decision-Making: A Psychological Analysis of Conflict, Choice and Commitment* (1977) (discussing why—and how—bad

calculus of the present doctrinal framework.⁶⁵ Important work also remains to be done on the influence of Rule 10b-5 and comparable legal rules on high-level corporate decisions in terms of how legal advice is rendered. My sense is that while the law has less of an influence on day-to-day managerial behavior than we have traditionally believed, there are some settings—highly “lawyered” transactions and events—where its effect is excessive in light of a variety of behavioral factors. Not the least of these may be the tendency of the lawyers to maximize their own control and influence in the decision-making process by overstating both the legal risk associated with Rule 10b-5 and their ability to deal with it.⁶⁶ All in all, the diffusion of legal knowledge in the corporate area may in fact be a more interesting and mysterious process than our current belief structure acknowledges.

If what we do not know about the investing process is indeed this great, then Rule 10b-5’s wobbliness is understandable, maybe even appropriate. We may still be early enough in our intellectual journey so as to render appealing—especially when one considers the rapidity of external change and the enforcement benefits of indeterminacy—the fits and starts that characterize the present common-law process. A tentative, fluid form of law suits agnosticism quite well.

Whether or not a retention of the open-ended character of Rule 10b-5 is substantively proper, I am quite convinced that a complete revision is highly unlikely. In part, the reasons for this conclusion are standard ones: the traditional fear of losing flexibility in the enforcement of the securities laws, and the less-often discussed fear of opening up the enforcement “crown jewel” of securities regulation to the vagaries and special interests of the political process.⁶⁷ To these reasons, we may add the current lack of confidence in any coherent view of the investing process, and the rapid pace of change in the structure of markets. In addition, I believe that a more subtle factor is operative.

I have long been curious about the prevalence and persistence of ambi-

decisions are made). I have recently completed a project that considers the claim that attorneys have an imperfect cognitive ability to identify client fraud, based on the teachings of cognitive dissonance and commitment theory. See generally Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers’ Responsibility for Clients’ Fraud*, 46 Vand. L. Rev. 75 (1993).

65. See *supra* text accompanying note 34.

66. The diffusion of law is an interesting and underexplored concept. Common sense suggests that, consciously or not, lawyers have an incentive to describe the law to their clients in a way that maximizes their own advantage—creating a classic moral hazard problem. For some thoughts in this direction from the standpoint of organization theory, see Lauren B. Edelman et al., *Professional Construction of Law: The Inflated Threat of Wrongful Discharge*, 26 Law & Soc’y Rev. 47 (1992). The tendency to distort the legal situation is also noted in John Flood’s study of the corporate lawyer. See John Flood, *Doing Business: The Management of Uncertainty in Lawyers’ Work*, 25 Law & Soc’y Rev. 41, 63-66 (1991).

67. In many ways, this was a principal reason for the SEC’s only grudging endorsement of the Federal Securities Code, and its lack of willingness to lobby strongly for it.

guity in various legal settings—whether it be in statutes, rules, or private contracts. Conventional theory holds that, apart from those instances when it is the product of simple carelessness, ambiguous legal words and phrases should only be used when the transaction costs associated with further refinement exceed the likely benefits to be derived from the clarification.⁶⁸ Normally, ambiguity is preferred only to the extent that future circumstances cannot be anticipated with reasonable precision, and no express *ex ante* risk allocation makes sense. This offers one explanation for why a preference for ambiguity would be apparent in the draftsmanship of Rule 10b-5.

Nevertheless, this explanation may not account in entirety for our tolerance of the vagueness of Rule 10b-5. Ambiguous language is frequently chosen not because of imperfect information, but because it is a way of deferring to an unpredictable future the question of who wins and who loses. It constitutes something of a lawyers' bet, facilitating compromise in an otherwise zero-sum setting. Research in cognitive psychology moreover suggests an additional reason. People—especially successful ones, imbued with high levels of self-esteem (like many lawyers)—habitually tend to view ambiguous cues through rose-colored glasses, seeing more opportunity than risk.⁶⁹ In many negotiation settings (whether the subject matter being drafted is a law, a rule, or a contract), ambiguity allows both sides to walk away with little sense of loss, with both sides wishfully seeing the agreed-to term in a hopeful light, or at least projecting such a benevolent interpretation to their constituencies.⁷⁰

Rule 10b-5 may well survive in part because of this adaptive capacity.

68. For an illustration of this point, with respect to legislative drafting, see McNollgast, *Positive Canons: The Role of Legislative Bargains in Statutory Interpretation*, 80 Geo. L.J. 705, 714-15 (1992); as to the choice of language in the private contracting literature, see Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: The Analysis of the Interaction Between Express and Implied Contract Terms*, 73 Cal. L. Rev. 261 (1985).

69. See Fiske & Taylor, *supra* note 4, at 215 (discussing individuals' perceptions of future events). This is a strong component in gambling behavior. See Thomas Gilovich, *Biased Evaluation and Persistence in Gambling*, 44 J. Pers. & Soc. Psychol. 1110 (1983).

70. It is interesting that when reforms of Rule 10b-5 are proposed, they tend to be almost as ambiguous and open ended as the rule itself. In 1987 and 1988, an ambitious effort was undertaken to define insider trading, and it received considerable support from the SEC, the private bar, and some members of Congress. Interestingly, the rule was drafted more to create the illusion of predictability than actual predictability: the duty to disclose, for instance, would depend on the presence of the "wrongful" misuse of information, i.e., that which constituted (directly or indirectly) "theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence." *Improper Activities in the Securities Industry: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 57 (1987). One has the distinct impression that this sort of compromise was reached largely because it allowed the more conservative members of the drafting group to see in the proposed formulation more clarity than was really there, while it allowed the more enforcement-oriented members the ability to see continued flexibility and force.

Lawyers—who are overwhelmingly responsible for the vitality of the rule, whether they are acting as judges, bureaucrats, advocates, or lobbyists—tend to view the rule from a litigation perspective, assessing likely outcomes in foreseeable cases. Regardless of where a lawyer's self-interest lies—be it in the case of the SEC and its staff, the Business Roundtable, the securities industry, or the private bar—it is possible to look at Rule 10b-5 in mildly hopeful terms, and to see some lingering opportunity for evolution toward desired objectives. Indeed, the rule's jurisprudence has thus far been broad enough to encompass aggressive investor protection, protection against strike suits, flexibility and clarity—all roughly at the same time, and without much apology for the inconsistency. Few statutory or rule-based reforms would offer such promise to all the affected parties; if, for example, the scope of the rule were to become defined with greater precision, any given interest would face a greater risk of unrecoverable loss. Perhaps, then, Rule 10b-5's ability to adapt to indeterminate future environments is a political survival trait as well as an intellectual one.

